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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

COMMENTS OF ROCHESTER
TELEPHONE CORPORATION

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Summary

The Commission's Notice[*/] initiating this proceeding requests comments on three broad issues: (a) the policy goals and direction of price cap regulation; (b) changes to the existing price cap plan; and (c) the transition to a fully competitive local exchange environment.

The Commission should refine the existing goals and policy direction that underlie its exchange carrier price cap plan. The current goals -- just, reasonable and nondiscriminatory rates, innovation and high quality services -- certainly remain valid. In today's environment, characterized by rapid technological change and a high degree of competition, the Commission should refine its goals to include: the preservation of universal service; the development of a national information infrastructure; the rapid introduction of new services; and fair and balanced access competition. Although these goals represent only refinements to the Commission's existing goals, they are nonetheless necessary to accommodate developing national policy and the dramatic changes in the industry.

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*/ The abbreviations used in this summary are defined in the body of the text.

These goals can only be met by a price cap plan that meets three requirements: (1) it provides strong efficiency, investment and innovation incentives by removing all rate of return constraints on exchange carrier performance; (2) it permits exchange carriers, like all other industry participants, to respond quickly and efficiently to consumer demand; and (3) it minimizes and equalizes the regulatory burdens faced by all market participants. In Part I of these comments, Rochester describes the major changes to the existing price cap plan that are essential for achieving the goals set forth above. Rochester responds to the specific baseline issues upon which the Commission requests comment in Part II of these comments.

Finally, the Commission correctly recognizes that the access business is rapidly becoming fully competitive. Any changes that the Commission adopts to the existing exchange carrier price cap plan should accommodate this market reality. Rochester discusses these transitional issues in Part III of these comments.

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COMMENTS OF ROCHESTER
TELEPHONE CORPORATION

Introduction

Rochester Telephone Corporation ("Rochester") submits these comments in response to the Commission's Notice initiating its fourth-year review of exchange carrier performance under price cap regulation.[1/] The Notice requests comments on three broad issues: (a) the policy goals and direction of price cap regulation;[2/] (b) changes to the existing price cap plan;[3/] and (c) the transition to a fully competitive local exchange environment.[4/]

1/ Price Cap Performance Review for Local Exchange Carriers, CC Dkt. 94-1, Notice of Proposed Rulemaking, FCC 94-10 (Feb. 16, 1994) ("Notice").

2/ Id., ¶¶ 31-34.

3/ Id., ¶¶ 38-91.

4/ Id., ¶¶ 92-100.

The Commission should refine the existing goals and policy direction that underlie its exchange carrier price cap plan. The current goals -- "ensuring that LEC rates are just, reasonable and nondiscriminatory and promoting a communications system that offers innovative, high quality services"[5/] -- certainly remain valid. In today's environment, characterized by rapid technological change and a high degree of competition, the Commission should refine its goals to include: the preservation of universal service; the development of a national information infrastructure; the rapid introduction of new services; and fair and balanced access competition. Although these goals represent only refinements to the Commission's existing goals, they are nonetheless necessary to accommodate developing national policy and the dramatic changes in the industry.

These goals can only be met by a price cap plan that meets three requirements: (1) it provides strong efficiency, investment and innovation incentives by removing all rate of return constraints on exchange carrier performance; (2) it permits exchange carriers, like all other industry participants, to respond quickly and efficiently to consumer demand; and (3) it minimizes and equalizes the regulatory burdens faced by all market participants. In Part I of

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5/ Id., ¶ 31.

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Finally, the Commission correctly recognizes that the access business is rapidly becoming fully competitive.[6/] Any changes that the Commission adopts to the existing exchange carrier price cap plan should accommodate this market reality. Rochester discusses these transitional issues in Part III of these comments.

Argument

I. THE COMMISSION SHOULD REFINE THE POLICY GOALS OF PRICE CAP REGULATION TO ACCOUNT FOR CHANGES WITHIN THE TELECOMMUNICATIONS INDUSTRY.

The Commission's initial exchange carrier price cap plan represented an historic step in moving away from traditional cost-of-service regulation. The Commission provided exchange carriers incentives to replicate the behavior of firms that operate in fully competitive markets. Rather than simply recovering expenses and earning a reasonable return on rate base, an exchange carrier's success (or failure) now depends,

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6/ Id., ¶¶ 8, 22.

to some extent, on its ability to operate efficiently and offer services that access customers demand.

Because the industry is experiencing dramatic change, the Commission should adjust, not only the specifics of the plan, but its policy direction and goals as well. By explicitly recognizing the need for universal service, a national information infrastructure, customer demand and regulatory parity, the Commission will establish the necessary policy direction to devise a new price cap plan that will significantly increase the benefits of price cap regulation to consumers and to the national economy as a whole.

A. Exchange Carriers Have Made Significant Public Interest Contributions Under Price Cap Regulation.

The Commission notes that, under price caps, the profitability of interstate access services has increased.[7/] At the same time, the Commission correctly observes that exchange carriers have: (a) substantially upgraded their networks; (b) made available a wide variety of new services to the public; (c) maintained and improved service quality; and (d) have done so while, at the same time, reducing access rates by over $2 billion since the initiation of price cap regulation.[8/] These observations are by no means

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7/ *Id.*, ¶ 26.

8/ *Id.*, ¶¶ 22-30.

contradictory. Indeed, they validate the Commission's decision -- over strenuous opposition -- to apply price cap regulation to the exchange carrier industry.

Rochester's experience confirms this choice. Price cap regulation was optional for Rochester. Nonetheless, it presented a substantial challenge. Rochester was not only relatively small for a Tier 1 exchange carrier, it owned a number of small Tier 2 exchange carriers that would also be required to convert to price cap regulation if Rochester so elected. Nonetheless, effective July 1, 1991, Rochester elected price cap regulation. That decision was sound as Rochester's exchange carrier family and, more importantly, its customers have benefited. In the aggregate, Rochester's access rates have declined by 10.3% since Rochester became subject to price cap regulation. Based upon 1993 demand, Rochester's customers and those of its exchange carrier subsidiaries have realized a savings of over $5.5 million, compared to total 1993 interstate revenues of $96.3 million. The access rates of the Tier 1 Rochester company are among the lowest in the nation. Certainly, these savings represent a tremendous benefit to Rochester's interstate access customers.

Rochester's customers have benefited in other ways as well. Under price caps, Rochester has introduced a variety of new services, including switched 56 kilobit service, fractional T1 service, 800 data base access, a variety of new pricing plans for high capacity DS-1 and DS-3 services and others. In addition, Rochester is poised to commence the first commercial trial of video dial tone service in the Nation.[9/]

Both Rochester and its Tier 2 subsidiaries have deployed advanced telecommunications infrastructures. Rochester now has deployed over 10,420 miles of fiber optic transmission facilities. Its switching facilities provide digital service to over 98% of the access lines in Rochester and over 93% of the access lines served by Rochester's Tier 2 price cap subsidiaries. SS7 capabilities are ubiquitously deployed in Rochester. Service quality has remained exceptional, as evidenced by Rochester's ARMIS 43-05 reports. Rochester's interstate access customers have substantially benefited under price cap regulation.

At the same time, Rochester has also benefited. The Commission correctly notes that Rochester's earnings have increased modestly under price caps.[10/] Rochester's Tier 2 subsidiaries, including its Minnesota and Iowa Vista companies,[11/] elected the 4.3% productivity offset effective

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9/ _See_ _Rochester Telephone Corporation_, File No. W-P-C-6867, Order and Authorization (March 25, 1994).

10/ Notice, ¶ 26.

11/ Vista Telephone Company of Minnesota and Vista Telephone Company of Iowa ("Vista") offer interstate access services under Vista's Tariff F.C.C. No. 1.

July 1, 1993, and Rochester itself has elected the 4.3% productivity offset effective July 1, 1994.

Rochester's experience demonstrates that the Commission's decision to adopt price cap regulation for exchange carriers resulted in the creation of a positive-sum game in which everyone benefited.[12/] The promise of price cap regulation, however, remains unfulfilled. As we address in subsequent sections of these comments, the Commission now possesses the opportunity to design a regulatory plan that will fully unleash the capabilities of exchange carriers to bring to their customers the full benefits of price, rather than profit, regulation.

B. The Commission Should Refine Its Price Cap Goals To Reflect a Changed Telecommunications Environment.

When the Commission first adopted price cap regulation, the goals it established -- just, reasonable and

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12/ Rochester has not independently examined whether price cap regulation has materially benefited the economy in general. The Wharton Study (see Notice, ¶ 12) predicted significant economic gains from reductions in the prices for telecommunications services. The Rochester, New York, metropolitan area is particularly telecommunications intensive. Large, research-oriented companies, such as Eastman Kodak, Bausch & Lomb, and Xerox, as well as the University of Rochester and the Rochester Institute of Technology, could only benefit from channeling resources from their telecommunications needs to other activities.

nondiscriminatory rates, efficiency and innovation[13/] -- were modest, but fair. Moreover, those goals remain valid today. However, to deliver the full benefits of price cap regulation to consumers and to the economy, the Commission should explicitly incorporate additional, complementary goals into its overall approach to the regulation of exchange carriers. Specifically, the Commission should recognize, as goals of price cap regulation:

-- the preservation and enhancement of universal service;

-- the development of a national information infrastructure;

-- the encouragement of new services and technologies to meet and anticipate consumer demand; and

-- the minimization and equalization of regulatory burdens on all participants in an increasingly competitive industry.

The proposed refinements represent different sides of a multi-faceted coin. Universal service has always been -- and should continue to remain -- a central aspect of the Commission's regulatory policy. The challenge facing the Commission is how best to preserve and enhance universal service in a fully competitive environment. It is no longer sound public policy -- nor feasible -- for exchange carriers' interstate access rates to reflect subsidy obligations that its

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13/ *Id.*, ¶ 31.

competitors do not bear. All market participants must share this burden.

The development of a national information infrastructure is equally vital. Telecommunications and access to the information age are vital in today's economy. The Commission should not, by regulatory decree, determine which companies participate in the deployment of the information age infrastructure and which do not. Rather, it should create an environment in which all market participants have the opportunity to meet that need.

Interstate access customers are highly sophisticated. They demand services and technologies that both meet and anticipate their needs and will not hesitate to turn to alternative suppliers to satisfy these demands if exchange carriers cannot. The Commission's Part 61 price cap and Part 69 access charge rules must incorporate the necessary flexibility to permit exchange carriers to respond quickly and decisively to such demand.

Regulatory parity is also essential. The Commission cannot continue to subject exchange carriers to burdens that their competitors do not face. Access competition is not the myth that some would like the Commission to believe. Competitive access providers now represent (as they have for a while) a substantial competitive presence.[14/] The Commission's Transport Rate Structure[15/] and Expanded Interconnection[16/] decisions will make such competition even more intense. In Rochester -- the 38th largest metropolitan area in the Nation -- FiberNet has deployed a fiber ring in the downtown Rochester area and is, apparently, highly successful in attracting access customers to its services, rather than to Rochester's.[17/] FiberNet has achieved this position without taking advantage of Rochester's special and switched access expanded interconnection offerings, despite those services being among the lowest-priced and least burdensome offerings

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14/ See id., ¶ 22.

15/ Transport Rate Structure and Pricing, CC Dkt. 91-213, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd. 7006 (1992), recon., 8 FCC Rcd. 5370 (1993), further recon. 8 FCC Rcd. 6233 (1993).

16/ Expanded Interconnection with Local Telephone Company Facilities, CC Dkt. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd. 7369 (1992), recon., 8 FCC Rcd. 127 (1993), further recon., 8 FCC Rcd. 7341 (1993).

17/ MFS, one of the largest competitive access providers in the Nation, has recently announced plans to acquire FiberNet.

available.[18] Rochester itself has proposed its Open Market Plan affirmatively to encourage local exchange competition.[19]

Local exchange competition is not only inevitable, it already exists. The Commission must reconcile the existing regulatory framework to this marketplace reality.

By refining the goals of price cap regulation as Rochester suggests, the Commission may adopt a focused set of policy goals and objectives that will guide specific changes to the existing price cap plan that will further enhance consumer and economic growth.

C. The Commission Should Adopt a Price Cap Plan That Best Addresses the Proposed Objectives.

To encourage the preservation of universal service, the deployment of a national information infrastructure, the introduction of new services and the promotion of full and fair competition, the Commission must modify its existing price cap plan in significant respects. In Part II of these comments,

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18/ E.g., Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection for Special Access, CC Dkt. 93-162, Comments on Direct Cases of Teleport Communications Group Inc. at A-2 (Sept. 20, 1993).

In addition, both Time Warner and ACC Corporation have announced plans to enter the local exchange business in Rochester.

19/ Rochester Telephone Corporation - Petition for Waivers of Part 61 Tariff Rules and Part 69 Access Charge Rules To Implement Its Open Market Plan, DA 93-687, Petition for Waiver (May 19, 1993).

Rochester responds to the specific baseline issues upon which the Commission requests comment. In this section, Rochester describes the critical changes that the Commission should adopt to its existing price cap regime.

1. The Commission Must Eliminate the Sharing and Low-End Adjustment Mechanisms.

The current price cap system has resulted in substantial consumer benefits. However, the full promise of price caps has yet to be realized, largely because the system -- through the sharing and low-end adjustment mechanisms -- remains anchored in cost-of-service regulation. A study prepared by Strategic Policy Research[20/] demonstrates that a four-year price cap plan that contains a 50/50 sharing mechanism provides only 18% of the efficiency incentives relative to unregulated competitive markets.[21/] The reasons are relatively straightforward. Cost-of-service regulation dulls efficiency incentives. Such a system does not fully reward firms subject to its constraints for marketplace successes; nor does it fully punish them for marketplace failures. Although there is little doubt that the current system has produced significant consumer benefits, these benefits could expand exponentially if the Commission

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20/ Strategic Policy Research, Regulatory Reform for the Information Age: Providing the Vision (1994).

21/ Id. at 23, Table 23.

were to sever the remaining ties to cost-of-service regulation. Indeed, if the Commission does nothing else in this proceeding, it should eliminate both the sharing and low-end adjustment mechanisms.

2. The Commission Should Substantially Readjust the Existing Baskets and Bands.

The excessively rigid and cumbersome structure of the price cap baskets and bands effectively inhibits truly competitive pricing behavior. The original price cap baskets and bands were relatively simple. Over time, however, the system has become unnecessarily cumbersome. Each major policy decision that affected exchange carriers' services carried with it substantial modifications to the price cap baskets and bands. For example, the Commission's zone density pricing plan[22/] -- a welcome step in the right direction[23/] -- created numerous new sub-baskets. Its transport rate restructuring[24/]

22/ BellSouth Telecommunications, Inc. - Zone Density Pricing Plans, DA 93-726, Order, 8 FCC Rcd. 4443 (1993).

23/ Although the Commission currently permits exchange carriers to adopt zone pricing, the circumstances under which exchange carriers may exercise this authority are far too narrow. E.g., Expanded Interconnection with Local Telephone Company Facilities, CC Dkt. 91-141 (Phase I), Petition of Rochester Telephone Corporation for Reconsideration and Clarification at 4-8 (Oct. 15, 1993).

24/ See Transport Rate Structure and Pricing, CC Dkt. 91-213, Second Report and Order, FCC 94-9 (Jan. 31, 1994).

had the same effect, as did its 800 data base decision.[25/] The result is an overly cumbersome system that constrains exchange carriers' abilities to respond to the competitive pressures that they face.

Rather than continue the existing baskets and bands, the Commission should adopt the access charge reforms proposed by the United States Telephone Association ("USTA").[26/] By rearranging the baskets along functional lines (e.g., transport, switching/features, public policy and other) and adjusting the degree of regulation based upon the competitive characteristics of specific services and geographic areas, the Commission will properly adjust the existing price cap rules to reflect the technological and competitive changes that are transforming the industry. The Commission has altered AT&T's price cap plan to take into account changes in the competitive circumstances facing AT&T.[27/] The changes in the industry that are affecting exchange carriers are no less profound.

25/ Provision of Access for 800 Service, CC Dkt. 86-10, Second Report and Order, 8 FCC Rcd. 907 (1993).

26/ See Reform of the Interstate Access Charge Rules, RM-8356, Petition for Rulemaking (Sept. 17, 1993).

27/ Price Cap Performance Review for AT&T, CC Dkt. 92-134, Report, 8 FCC Rcd. 6968 (1993); Competition in the Interstate Interexchange Market, CC Dkt. 90-132, Report and Order, 6 FCC Rcd. 5880 (1991), recon., 6 FCC Rcd. 7569 (1991), further recon., 7 FCC Rcd. 2677 (1992).

3. The Commission Should Substantially Modify the Rules Governing the Introduction of New Services.

Adoption of the USTA access charge reform proposal will permit exchange carriers to respond more rapidly and efficiently to consumer demand. Under the USTA proposal, rate elements -- other than public policy elements -- would no longer be codified. Thus, at the least, exchange carriers would not need to traverse the lengthy and cumbersome waiver process that currently adds significant delay to the introduction of new switched access services. Similarly, by streamlining the price cap rules governing the introduction of new services in the manner suggested by USTA, the Commission will also help facilitate exchange carriers' abilities to introduce new services that customers demand.

Finally, adoption of the USTA proposal will provide a transitional framework for the Commission to utilize in moving to a less regulated environment. Classification of areas and services as initial, transitional and competitive -- each with their own pricing rules based upon objective competitive considerations -- will itself govern the transition to a less regulated environment.

4. The Commission Should Adopt a System That Provides for Regulatory Parity for Exchange Carriers and Their Competitors.

Today, exchange carriers face significant regulatory burdens that do not confront their competitive rivals.

Although both exchange carriers and their competitors must now file tariffs, for example, the filing and review requirements are far different. Although the Commission has afforded exchange carriers a degree of pricing flexibility -- through the baskets and bands and through decisions such as its zone density pricing authority[28/] -- exchange carriers' competitors have substantially greater flexibility. Competitive access providers may file ranges of rates[29/] -- which permit essentially unlimited pricing flexibility -- while exchange carriers cannot. This discrepancy alone provides exchange carriers' competitors an enormous competitive advantage, of which such competitors have taken full advantage. In the highly competitive access business, such discrepancies are counterproductive and unsustainable.

Similarly, exchange carriers, but not their competitors, are subject to a variety of reporting, cost allocation, affiliate transaction and similar rules that artificially raise their costs of doing business. Although the Commission has taken steps to mitigate this disadvantage, it should continue to examine ways to reduce the disparity in regulatory burdens

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28/ E.g., Expanded Interconnection with Local Telephone Company Facilities, CC Dkt. 91-141 (Phase I), Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd. 7374, 7422-36 (1993).

29/ Tariff Filing Requirements for Nondominant Common Carriers, CC Dkt. 93-36, Memorandum Opinion and Order, 8 FCC Rcd. 6752, 7658-89 (1993).

faced by exchange carriers, compared to their competitors.

By refining its price cap goals and adopting a system designed to meet these goals, the Commission will take a significant step toward creating a regulatory environment that preserves universal service, enhances efficiency incentives, promotes the introduction of new services and provides a framework for fair and balanced access competition.

II. THE COMMISSION SHOULD ADOPT SPECIFIC, PRO-COMPETITIVE CHANGES TO ITS EXCHANGE CARRIER PRICE CAP PLAN.

The Commission has requested comment on a number of baseline issues that largely address changes to the existing price cap plan.[30/] In Part I of these comments, Rochester discussed the critical changes that are a necessary outcome of this price cap performance review. Here, Rochester addresses the baseline issues upon which the Commission has requested comment.

A. Baseline Issue 1 - Infrastructure Development

As Rochester described above,[31/] the Commission's price cap plan has created incentives for exchange carriers to deploy the necessary facilities to create a national information infrastructure, incentives on which Rochester has acted. The

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30/ Notice, ¶¶ 36-91.

31/ *See supra* at 5-6.

changes to the price cap plan that Rochester advocates in these comments will further strengthen these incentives.

B. Baseline Issue 2 - Baskets and Bands

In Part I,[32/] Rochester demonstrated that the existing baskets and bands are obsolete. The Commission should replace the existing baskets and bands with those contained in the access charge reform proposal advocated by USTA.

C. Baseline Issue 3 - Productivity Factor

The Commission requests comment on whether it should either increase the productivity factors of 3.3% or 4.3% -- including the consumer productivity dividend -- or reset (presumably reduce) exchange carriers' price cap indices as part of its fourth-year review.[33/] Although the Commission should consider changes to the existing productivity offset, it should reject outright a one-time change in the price cap indices.

Rochester understands that USTA will submit with its comments a long-run total factor productivity study conducted by Professor Christiansen. In its initial price cap order, the Commission relied upon total factor productivity studies in determining the appropriate productivity factors to be

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32/ *See supra* at 13-14.

33/ Notice, ¶ 46.

incorporated into the price cap formula.[34/] A long-run total factor productivity study -- of the type conducted by Professor Christiansen -- provides the most reasonable basis for resetting the price cap productivity offsets.

The Commission should not, however, adopt a one-time reduction in the price cap indices. Such a step would do no more than recapture whatever efficiency gains that exchange carriers have achieved under the current form of price cap regulation. This approach would re-introduce all of the inefficiencies of traditional cost-of-service regulation, a step that the Commission has indicated that it does not intend take.[35/]

Moreover, there is no evidence that exchange carriers' earnings have been excessive under price caps or that existing earnings levels are inappropriate. There is simply no basis for the Commission to introduce any earnings adjustment --

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34/ Policy and Rules Concerning Rates for Dominant Carriers, CC Dkt. 87-313, Second Report and Order, 5 FCC Rcd. 6786, 6796-99 (1990) ("Price Cap Second Report").

35/ Notice, ¶ 45.

whether in the form of a one-time reduction in the price cap indices or a mechanism tied to changes in interest rates[36/] -- into its price cap plan.

D. <u>Baseline Issue 4 - Sharing</u>

For the reasons described above,[37/] the Commission should eliminate the sharing and low-end adjustment mechanisms.

E. Baseline Issue 5 - Common Line <u>Formula</u>

The common line formula that the Commission initially adopted balances the gains from increased growth in minutes per common line between exchange carriers and their interstate access customers.[38/] The existing common line formula recognizes that both exchange and interexchange carriers may influence interstate usage of common lines. When the Commission adopted the existing common line formula, it struck a reasonable balance between the interests of exchange carriers and their interstate access customers. There is no

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36/ The Commission should not adopt its proposal to index an implicit (or explicit) authorized return to changes in interest rates. Such a mechanism would continue the link between price and earnings regulation, which the Commission should eliminate entirely. <u>See</u> <u>supra</u> at 12-13. Moreover, the proposal assumes that a direct link between changes in interest rates and changes in a firm's cost of capital exists. That assumption is false. Prevailing interest rates constitute only one of a number of factors that affect a firm's cost of capital.

37/ <u>See</u> <u>id</u>.

38/ Notice, ¶ 56